



0000155961

MEMORANDUM

RECEIVED

AZ CORP COMMISSION
DOCKET CONTROL

2014 SEP 17 AM 11 49

TO: Docket Control

FROM: Steve M. Olea
Director
Utilities Division**ORIGINAL**

DATE: September 16, 2014

RE: STAFF REPORT FOR THE APPLICATION OF UNS ELECTRIC, INC. AND
UNS GAS, INC. FOR THE APPROVAL OF JOINT FINANCING.
(DOCKET NOS. E-04204A-13-0447 AND G-04204A-13-0447)

Attached is the Staff Report for UNS Electric, Inc. and UNS Gas, Inc.'s joint application requesting authorization for various financing transactions.

Staff recommends that UNS Electric, Inc. and UNS Gas, Inc. ("Companies") be authorized to (1) refinance their joint revolving credit facility that expires in November 2016; (2) increase the amount of credit available under one or more revolving credit facilities to each company, individually, from \$70 million to \$100 million; (3) refinance long-term indebtedness maturing in August 2015; (4) increase the amount of long-term indebtedness outstanding at UNS Electric by up to \$80 million and at UNS Gas by up to \$50 million; (5) finance the purchase of an interest in Gila River Unit 3 ("Gila River") by allowing UNS Electric to issue additional debt up to \$35 million and accept new equity contributions up to \$35 million; (6) provide security for any such financing transactions; and (7) enter into these financings up to December 31, 2019. Staff further recommends that any authority granted in this proceeding be conditioned upon the Companies' compliance with their debt covenants, that the Companies maintain a capital structure with at least 40 percent equity, and that all previously granted but unused authority to incur debt be cancelled.

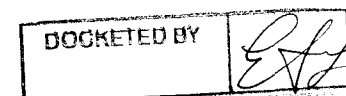
Any party who wishes may file comments to the Staff Report with the Commission's Docket Control on or before September 30, 2014.

SMO:GWB:tdp | MAS

Originator: Gerald W. Becker

Arizona Corporation Commission
DOCKETED

SEP 17 2014



Service List for: UNS Electric, Inc. and UNS Gas, Inc.
Docket Nos. E-04204A-13-0447 and G-04204A-13-0447

Michael Patten
Roshka DeWulf & Patten, PLC
One Arizona Center
400 East Van Buren Street, Suite 800
Phoenix, Arizona 85004

Bradley Carroll
Legal Department-HQE910
Post Office Box 711
Tucson, Arizona 85702

**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

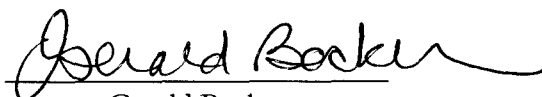
**UNS ELECTRIC, INC. AND UNS GAS, INC.
DOCKET NO. E-04204A-13-0447 AND G-04204A-13-0447**

**APPLICATION FOR A FINANCING ORDER
AUTHORIZING VARIOUS FINANCING TRANSACTIONS**

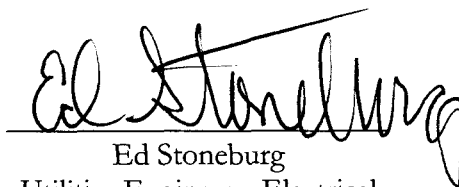
SEPTEMBER 16, 2014

STAFF ACKNOWLEDGMENT

The Staff Report for UNS Electric, Inc. and UNS Gas, Inc., Docket Nos. E-04204A-13-0447 and G-04204A-13-0447 is the responsibility of the Staff members listed below. Gerald Becker is responsible for the financial review and analysis. Ed Stoneburg is responsible for the engineering review and analysis.

A handwritten signature in cursive script, reading "Gerald Becker", written over a horizontal line.

Gerald Becker
Executive Consultant

A handwritten signature in cursive script, reading "Ed Stoneburg", written over a horizontal line.

Ed Stoneburg
Utilities Engineer - Electrical

EXECUTIVE SUMMARY
UNS ELECTRIC, INC. AND UNS GAS, INC.
DOCKET NOS. E-04204A-13-0447 AND G-04204A-13-0447

On December 18, 2013, UNS Electric, Inc. and UNS Gas, Inc. ("Applicants" or "Companies"), a wholly owned subsidiaries of UniSource Energy Corporation ("UNS"), filed an application with the Arizona Corporation Commission ("Commission") requesting authorization for various financing transactions.

Staff recommends the following:

(1) Authorize the Companies to refinance their joint revolving credit facility that expires in November 2016;

(2) Authorize the Companies to increase the amount of credit available under one or more revolving credit facilities to each company, individually, from \$70 million to \$100 million;

(3) Authorize the Companies to refinance long-term indebtedness maturing in August 2015;

(4) Authorize the Companies to increase the amount of long-term indebtedness outstanding at UNS Electric by up to \$80 million and at UNS Gas by up to \$50 million;

(5) Authorize the Companies to finance the purchase of an interest in Gila River Unit 3 ("Gila River") by allowing UNS Electric to issue additional debt up to \$35 million and accept new equity contributions up to \$35 million;

(6) Authorize the Companies to provide security for any such financing transactions;

(7) Authorize the Companies to enter into these financings up to December 31, 2019;

(8) The Commission cancel all previously authorized but unused borrowing authority;

(9) Establish as a compliance item in this matter, a requirement for the Companies to file with Docket Control, within 60 days of the execution of any financing transaction authorized herein, a notice confirming that such execution has occurred and a certification by an authorized officer that the terms of the financing fully comply with the authorizations granted; and

(10) Require the Companies to make available to Staff, upon request, a copy of any loan documents executed pursuant to the authorization granted herein.

(11) That any authority granted herein be conditioned upon the Companies having at least 40 percent equity and that the Companies are in full compliance with their debt covenants including but not limited to the required "Interest Earned Ratio" of 2.50.

(12) That in the event that either Company's equity percentage falls below 40 percent, the Companies shall file an equity improvement plan with the Commission within 60 days.

TABLE OF CONTENTS

| | <u>PAGE</u> |
|---|-------------|
| INTRODUCTION | 1 |
| NOTICE | 1 |
| COMPLIANCE..... | 1 |
| BACKGROUND | 1 |
| DESCRIPTION OF PROPOSED FINANCING | 1 |
| PURPOSE..... | 3 |
| ENGINEERING ANALYSIS..... | 4 |
| FINANCIAL ANALYSIS | 5 |
| CAPITAL STRUCTURE | 6 |
| INTEREST EARNED RATIO (“RATIO”) AND EQUITY LEVELS | 7 |
| CASH COVERAGE RATIO | 8 |
| CONCLUSIONS AND RECOMMENDATIONS..... | 8 |

SCHEDULES

| | |
|---|-------|
| UNS Electric – Financial Analysis | GWB-1 |
| UNS Gas – Financial Analysis..... | GWB-2 |

ATTACHMENT

| | |
|-------------------------|---|
| Engineering Report..... | A |
|-------------------------|---|

INTRODUCTION

On December 18, 2013, UNS Electric, Inc. and UNS Gas, Inc. ("UNS Electric" or "UNS Gas" or "Company" or "Companies") filed an application with the Arizona Corporation Commission ("Commission") requesting authorization of various financing transactions.

NOTICE

On March 28, 2014, the Companies filed an Affidavit of publication verifying public notice of its financing application. The Companies published notices of its financing application in *The Arizona Daily Sun*, *the Kingman Daily Miner*, *the Courier*, and *Today's News-Herald* on March 24, 2014, and in the *Nogales International* on March 25, 2014. The affidavits of publication along with copies of the Notice are docketed.

COMPLIANCE

A check with the Utilities Division Compliance Section database indicates that as of July 24, 2014, UNS Electric is not delinquent on any compliance items.

BACKGROUND

The Companies are wholly owned subsidiaries of the UniSource Energy Services, Inc., the parent of which is UNS Energy Corporation. The Companies are for-profit Class "A" Arizona public service corporations with their principal offices located in Tucson, Arizona. UNS Electric is a vertically integrated electric utility serving approximately 92,500 retail customers in Mohave and Santa Cruz counties. UNS Electric owns and operates generation facilities that meet a portion of its power requirements. UNS Gas is a gas distribution company serving approximately 147,000 retail customers in Mohave, Yavapai, Coconino, and Navajo counties in Northern Arizona, as well as Santa Cruz County in Southeast Arizona.

The Companies' currently have financing authority as granted by the Commission in Decision No. 71917; however, that authority will expire on December 31, 2014.

On August 15, 2014, Fortis acquired UNS Energy Corporation (Docket No. E-04230A-14-0011). Tucson Electric Power, UNS Electric and UNS Gas are now part of Fortis, and reportedly the unsecured credit rating of Tucson Electric Power has already improved.

DESCRIPTION OF PROPOSED FINANCING

In this Application, UNS Electric and UNS Gas request an order stating that the approval of this application is in the public interest. More specifically, the Companies seek a Commission order authorizing:

- UNS Electric and UNS Gas to enter into one or more credit agreements, and to enter into agreements to refinance any such credit agreements, which may consist of one or more

revolving credit facilities so long as, after giving effect to the entry of such a facility, the amount of credit available under such facilities to each company, individually, does not exceed \$100 million^{1 2};

- UNS Gas to refinance its \$50 million in long-term indebtedness due in August 2015, and to issue up to an additional \$50 million of long-term debt to fund capital expenditures and for general corporate purposes;
- UNS Electric to refinance its \$80 million in long-term indebtedness due in August 2015, and to issue up to \$80 million of additional long-term debt to fund capital expenditures and for general corporate purposes;
- UNS Electric to finance the purchase of an interest in Gila River by allowing new debt, in addition to the authorization to issue long-term debt described above, up to \$35 million and accept new equity contributions of up to \$35 million over and above any contributions that could otherwise be made under Commission rules and orders, and;
- UNS Electric and UNS Gas to enter into these transactions on or before December 31, 2019.

The Companies further state that within 90 days of the completion of any financing transaction made pursuant to the requested Commission order, UNS Electric and UNS Gas would make a compliance filing with the Commission in which UNS Electric and UNS Gas would provide copies of the relevant agreements and provide a description of the business rationale for such financing or refinancing, including a demonstration that the rates and terms received by UNS Electric and UNS Gas were fair and reasonable under prevailing market conditions.

In its application, the Companies propose that authority granted in this proceeding be conditioned upon the requirements set forth in Decision No. 71917. That decision conditioned UNS Electric's and UNS Gas's authority to issue additional long-term debt (excluding debt issued under revolving credit facilities and long-term debt being issued to refinance debt) upon the borrowing entity having equity equal to at least 33 percent of its total capital and a Cash Coverage Ratio ("CCR") of at least 1.75 when equity is between 33 and 40 percent of total capital, or a CCR of at least 1.25 if equity is 40 percent or higher of total capital. The application further states that under that order:

- the equity ratio and CCR is determined on a pro forma basis after giving effect to the issuance of the long-term debt to be issued pursuant to the authority and the discharge of the any long-term debt being refunded or refinanced thereby;

¹ Present authority under Decision No. 71917 provides for up to \$100 million of borrowing for both Companies but limits the borrowing for each Company to \$70 million.

² Staff is treating borrowings under the revolver as short-term debt.

- the equity ratio is the ratio of (a) common stock equity to (b) total capitalization, using the most recently audited financial statements as adjusted for capital contributions, distributions, and issuances, repayments or purchases of debt or equity occurring after the most recently audited financial statements;
- total capitalization is defined as the sum of common stock equity, preferred stock, long-term debt (including current maturities thereof) and capital lease obligations (including current obligations under capital leases);
- the CCR is the ratio of (a) the sum of operating income, depreciation and amortization expense for the twelve-month period ending on the last day of the period covered by the most recently audited financial statements, to (b) interest expense for the twelve-month period ending on the last day of such period minus interest expense for such period for any indebtedness being and having been refinanced or refunded with the proceeds of long-term debt being and having been issued subsequent to such period plus interest expense for twelve months on the indebtedness being and having been issued subsequent to such period (calculated, in the case of indebtedness bearing a floating rate of interest at the rate initially in effect on the date of issuance thereof); and
- future changes in Generally Accepted Accounting Practices ("GAAP") that have the effect of lowering the borrowing entity's equity will be exempted from the equity and cash coverage ratio tests until the Commission makes a determination. The borrowing entity shall make a filing with the Commission requesting such a determination within 30 days after the borrowing entity files or the borrowing entity's affiliate (when the borrowing entity's affiliate includes the borrowing entity's results from operations and financial position) files its quarterly report on Form 10-Q or its annual report on Form 10-K with the SEC following the end of the fiscal quarter in which the GAAP change occurs.

The Companies further state that it is reasonable and prudent to condition the issuance of additional long-term indebtedness (excluding debt issued under revolving credit facilities and long-term debt being issued to refinance debt) upon such equity and cash coverage ratios tests and propose that the authorization for additional long-term debt (excluding debt issued under revolving credit facilities and long-term debt being issued to refinance debt) requested hereby be similarly conditioned. UNS Electric and UNS Gas believe that the amount of financing authority requested is reasonable and prudent and will not diminish either Company's financial integrity.

PURPOSE

UNS Electric and UNS Gas intend to use their revolving credit facilities for the following purposes: (i) as a source of liquidity for working capital purposes; (ii) to issue letters of credit to provide credit enhancement to counterparties for UNS Electric's and UNS Gas's energy procurement and hedging activities; and (iii) for other lawful corporate purposes. UNS Electric and UNS Gas intend to use the proceeds from the issuance of new long-term indebtedness for the following purposes: (i) refinance existing long-term indebtedness; (ii) finance a portion of their respective capital expenditure program for the next five years; (iii) pay down any outstanding

borrowings under the UNS Electric / UNS Gas revolving credit facility; and (iv) in the case of UNS Electric, finance a portion of UNS Electric's acquisition of an interest in Gila River. According to the application, UNS Gas anticipates cumulative capital expenditures of \$72 million and UNS Electric anticipates cumulative capital expenditures of \$190 million (exclusive of expenditures for Gila River) for the periods 2013 to 2017.

ENGINEERING ANALYSIS

Based on Staff's engineering review of UNS Electric's capital budget and related information provided by UNS Electric in response to Staff data requests, Staff concludes:

- UNS Electric is currently operating and maintaining its electric system in a reliable manner based upon UNS Electric reliability indices. As noted, however, there is an upward trend in SAIDI and SAIFI, and UNS Electric agreed in Decision No. 74235 to implement a procedure to target annual maintenance toward its worst performing circuits identified by service area and reliability indices, which Staff believes should help reverse the upward trend.
- UNS Electric's capital budget appears to adequately address the needs of the projected customer and load growth in UNS Electric's service territory. UNS Electric's capital budget anticipates capital expenditures to connect new customers, to provide continued capital improvements to the system both for serving increased system loads and to replace aging infrastructure, to maintain its power plants, and to upgrade general plant such as radio communication systems.
- UNS Electric's capital expenditures on its existing generation, and its transmission and distribution infrastructure upgrades and new additions appear appropriate and reasonable. The projected costs reviewed by Staff seem reasonable compared to UNS Electric's historic expenditures, which to date have resulted in reliable service, and also account for anticipated future needs. The acquisition price for Gila River is substantially below the cost of constructing a comparable new generating plant and meets the needs for baseload/intermediate capacity identified in UNS Electric's 2012 Integrated Resource Plan ("IRP").
- Based upon Staff's review of UNS Electric's economic analysis and the Company's need to reduce its reliance on short term market purchases, Staff concludes the acquisition of Gila River appears reasonable. Staff is concerned that UNS Electric did not solicit long term purchase power agreements, but since Staff's evaluation of financing applications does not include a prudency review of the actions proposed by the requesting company, this concern is more appropriately addressed if and when UNS Electric seeks to recover the costs associated with Gila River in its rates. UNS Electric should be aware that Staff's review of any such future filing may include an evaluation of whether or not a long term power purchase agreement would have been a better alternative.

- Based upon a review by the Utilities Division Compliance Section, UNS Electric currently has no delinquent Commission compliance items.

These Staff conclusions do not imply any specific treatment of rate base for rate making purposes in any future rate filings by the Company.

FINANCIAL ANALYSIS

If all amounts requested by UNS Electric were to be fully executed, UNS Electric would increase its short term debt from \$22.15 million to \$122.15 million, increase its long term debt from \$130 million to \$245 million and increase its equity from \$145.6 million to \$180.6 million. If fully executed, the proposed transactions would cause UNS Electric's equity to decrease from 48.9 percent to 33.0 percent of total capitalization.

If all amounts requested by UNS Gas were to be fully executed, UNS Gas would increase its short term debt from zero million to \$100 million, increase its long term debt from \$100 million to \$150 million, and its equity would be unchanged at 93.1 million. If fully executed, the transactions would cause UNS Gas's equity to decrease from 48.2 percent to 27.1 percent of total capitalization.

Consistent with the financing authority granted in Decision No. 71917, the Companies request a combination of cash flow and balance sheet parameters as needed to provide a reasonably broad financial perspective. Equity-to-total capitalization is an effective parameter for providing a balance sheet perspective of financial leverage and risk. The CCR provides a measure of a borrower's ability to pay interest expenses with operating cash flow. CCR combined with equity-to-total capitalization can be effective for monitoring appropriate indebtedness. Accordingly, Staff concludes that equity-to-total capitalization and CCR parameters are effective for placing conditions on debt issuances within a framework of threshold authorizations.

Staff further recognizes that the Companies' debt covenants do not include the usual Debt Service Coverage ("DSC") and Times Interest Earned Ratio ("TIER") considerations. Instead, the debt covenants include an Interest Earned Ratio ("ICR") and a limit on the maximum debt to equity ratio. In response to Staff DR 4.08, the Companies state that the covenants on their present debt instruments are that debt to total capitalization shall not exceed 65 percent and that the Ratio must be at least 2.50 for the previous four quarters. The ICR is the Company's Net Income plus Depreciation and Amortization Expense, plus Income Tax Expense to equal the Consolidated Income Available for Interest Charges, divided by total interest incurred which is Interest Expense plus any capitalized interest. For purposes of Staff's analysis, the 65 percent maximum limit on debt is satisfied by a minimum equity level of 35 percent.

Staff has calculated the ICR and the equity percentages for both Companies on the basis that the amounts requested to be authorized are fully drawn. The ICRs for UNS Electric and UNS Gas are 2.48 and 2.53, respectively. When fully drawn the debt total requested would result in equity percentages of 33 percent and 27.1 percent for UNS Electric and UNS Gas, respectively. Accordingly, Staff is concerned that the Companies could be in violation of its debt covenants if the requested debt authorizations were fully drawn by either Company and that the equity levels would

be significantly lower than the minimum of 40 percent that is typically considered to be financially prudent.

Staff disagrees with the Companies' request to exclude activity under its revolving debt in the calculation of financial ratios because the debt covenants associated with the revolving debt contemplate all debt and therefore must be considered in order for the Companies to meet this stricter covenant.

Capital Structure

UNS Electric

At December 31, 2013, UNS Electric's capital structure consisted of 7.4 percent short-term debt, 43.7 percent long-term debt, and 48.9 percent equity (Table 1, below). Staff usually considers equity at 40 percent of total capital as the minimum financially prudent capital structure for an investor owned utility with access to the capital markets. If the amounts requested to be authorized were to be fully drawn, UNS Electric's equity would decrease to 33.0 percent as shown on attached Schedule GWB-1.

| Table 1 | | |
|---|-----------|--------|
| UNS Electric's Capital Structure as of December 31, 2013³ | | |
| (in '000's) | | |
| Short-term Debt | \$ 22,150 | 7.4% |
| Long-term Debt | \$130,000 | 43.7% |
| Common Equity | \$145,601 | 48.9% |
| Total Capital | \$297,751 | 100.0% |

Staff concludes that any general authorization for UNS Electric to incur short-term (revolver) debt or long-term debt within the thresholds as proposed by UNS Electric should be subject to the condition that, subsequent to any debt issuance, common equity represents no less than 40 percent total capital. Staff also concludes that UNS Electric should ascertain compliance with its Ratio requirements in its debt covenants and refrain from any transaction that would create a failure to comply with those covenants.

³ Based on the Company's audited financials.

UNS Gas

At December 31, 2013, UNS Gas's capital structure consisted of 51.8 percent long-term debt, and 48.2 percent equity (Table 2, below). Staff usually considers equity at 40 percent of total capital as the minimum financially prudent capital structure for an investor owned utility with access to the capital markets. If the amounts requested to be authorized were to be fully drawn, UNS Gas's equity would decrease to 27.1 percent as shown on attached Schedule GWB-2.

| Table 2 | | |
|--|-----------|--------|
| UNS Gas's Capital Structure as of December 31, 2013 ⁴ | | |
| (in '000's) | | |
| Long-term Debt | \$100,000 | 51.8% |
| Common Equity | \$93,082 | 48.2% |
| Total Capital | \$193,082 | 100.0% |

Staff concludes that any general authorization for UNS Gas to incur short-term (revolver) debt or long-term debt within a threshold as proposed by UNS Gas should be subject to the condition that, subsequent to any debt issuance subject to the long-term debt threshold, common equity represents no less than 40 percent total capital. Staff also concludes that UNS Gas should ascertain compliance with its Ratio requirements and refrain from any transaction that would create a failure to comply with those covenants.

Interest Earned Ratio ("Ratio") and Equity Levels

In response to Staff Data Request 4.08, the Companies indicate that the debt covenants on existing debt instruments include an ICR which is calculated differently from the TIER that is more commonly used by Staff in its evaluation of requests for authority to incur debt. The debt covenants require a ICR with minimum of 2.50 and maximum debt as a percentage of total capital of 65 percent. The Companies expect that the proposed debt will have the same debt covenants as the existing debt.

Staff has calculated the present ICR for both Companies and on a pro forma basis reflecting full drawing of the amounts requested and has determined the pro forma ICR amounts of 2.48 and 2.53 for UNS Electric and UNS Gas, respectively.

⁴ Based on the Company's audited financials.

Staff recommends that any authority granted in this proceeding be conditioned upon the Companies' compliance with its debt covenants, including the ICR amounts. Staff further recommends that any authority granted in this proceeding be conditioned upon the Companies' compliance to the maximum debt percentages and in the event that the Companies' equity percentages fall below 40 percent, the Companies shall file an equity improvement plan with the Commission within 60 days.

Cash Coverage Ratio

Although not specifically required by their debt covenants, the Companies propose to condition its authority to incur debt on meeting a CCR of 1.75. A CCR represents the number of times internally generated cash covers required interest payments on short-term and long-term debt. A CCR greater than 1.0 means that operating cash flow is greater than interest expense.

Staff concludes that any general authorization for the Companies to incur debt should be more closely aligned with the debt covenants associated with the proposed debt. Staff recommends that a CCR requirement would be unnecessary in this proceeding. However, for informational purposes, Staff has calculated the CCRs for both Companies on a pro forma basis reflecting full drawing of the amounts requested and has determined the pro forma CCRs to be 2.03 and 1.85 for UNS Electric and UNS Gas, respectively.

CONCLUSIONS AND RECOMMENDATIONS

Staff concludes that incurrence of the short-term and long-term debt (including revolving credit facilities) for which UNS requests authorization, is within its corporate powers, is compatible with the public interest, would not impair its ability to provide services and would be consistent with sound financial practices, subject to the conditions set forth below.

Staff recommends the following:

(1) Authorize the Companies to refinance their joint revolving credit facility that expires in November 2016;

(2) Authorize the Companies to increase the amount of credit available under one or more revolving credit facilities to each company, individually, from \$70 million to \$100 million;

(3) Authorize the Companies to refinance long-term indebtedness maturing in August 2015;

(4) Authorize the Companies to increase the amount of long-term indebtedness outstanding at UNS Electric by up to \$80 million and at UNS Gas by up to \$50 million;

(5) Authorize the Companies to finance the purchase of an interest in Gila River Unit 3 by allowing UNS Electric to issue additional debt up to \$35 million and accept new equity contributions up to \$35 million;

- (6) Authorize the Companies to provide security for any such financing transactions;
- (7) Authorize the Companies to enter into these financings up to December 31, 2019;
- (8) The Commission cancel all previously authorized but unused borrowing authority;
- (9) Establishing as a compliance item in this matter, a requirement for Companies to file with Docket Control, within 60 days of the execution of any financing transaction authorized herein, a notice confirming that such execution has occurred and a certification by an authorized officer that the terms of the financing fully comply with the authorizations granted; and
- (10) Require the Companies to make available to Staff, upon request, a copy of any loan documents executed pursuant to the authorization granted herein.
- (11) That any authority granted herein be conditioned upon the Companies having at least 40 percent equity and that the Companies are in full compliance with their debt covenants including but not limited to the required "Interest Earned Ratio" of 2.50.
- (12) That in the event that either Company's equity percentage falls below 40 percent, the Companies shall file an equity improvement plan with the Commission within 60 days.

FINANCIAL ANALYSIS

Selected Financial Data To Show Effects of the Proposed Debt

| | [A] | | [B] | |
|----|---|---------------|---|----------------------|
| | Actual financial information for the 12 months ending 12/31/2013 | | Pro Forma financial information with issuance of the recommended debt/equity | |
| 1 | Net Income | \$ 12,753,000 | \$ 12,753,000 | |
| 2 | Depreciation & Amort. | 18,839,000 | 18,839,000 | |
| 3 | Income Tax Expense | 7,031,000 | 7,031,000 | |
| 4 | | | | |
| 5 | Interest Expense | 7,725,689 | 15,550,905 | |
| 6 | Repayment of Principal | 0 | 0 | |
| 7 | Consolidated Income Available for Interest Charges [1+2+3+5] | \$ 46,348,689 | \$ 54,173,905 | |
| 8 | INTEREST EARNED RATIO ("RATIO") | | | |
| 9 | [1+2+3+5] ÷ [5], or [7 ÷ 5] | 5.00 | 2.48 | |
| 10 | CCR * | | | |
| 11 | [1+2] ÷ [5] | 4.09 | 2.03 | |
| 12 | Short-term Debt (Revolver) | \$22,150,000 | 7.4% | \$122,150,000 22.3% |
| 13 | Long-term Debt | \$130,000,000 | 43.7% | \$245,000,000 44.7% |
| 14 | Common Equity | \$145,601,000 | 48.9% | \$180,601,000 33.0% |
| 15 | Total Capital | \$297,751,000 | 100.0% | \$547,751,000 100.0% |

[A] 2013 actual financial information

[B] Column [A] adjusted to reflect issuance of an additional \$80M of long-term debt,
\$35M of debt and \$35M of equity to help fund the purchase of Gila3, and the issuance of
\$100M of debt under a revolving credit facility.

- Calculated using Net Income vs. the Operating Income usually used by Staff

FINANCIAL ANALYSIS

Selected Financial Data To Show Effects of the Proposed Debt

| | | [A] | | [B] |
|----|--|---|--------|--|
| | | Actual financial information for the 12 months ending 12/31/2013 | | Pro Forma financial information with issuance of the recommended debt |
| 1 | Net Income | \$ 10,876,000 | | \$ 10,876,000 |
| 2 | Depreciation & Amort. | 8,884,000 | | \$ 8,884,000 |
| 3 | Income Tax Expense | 7,226,000 | | \$ 7,226,000 |
| 4 | | | | |
| 5 | Interest Expense | 6,109,067 | | 10,683,769 |
| 6 | Repayment of Principal | 0 | | 0 |
| 7 | Consolidated Income Available for Interest Charges [1+2+3+5] | \$ 33,095,067 | | \$ 37,669,769 |
| 8 | INTEREST EARNED RATIO ("RATIO") | | | |
| 9 | [1+2+3+5] ÷ [5], or [7 ÷ 5] | 4.42 | | 2.53 |
| 10 | CCR* | | | |
| 11 | [1+2] ÷ [5] | 3.23 | | 1.85 |
| 12 | Short-term Debt (Revolver) | \$0 | 0.0% | \$100,000,000 29.1% |
| 13 | Long-term Debt | \$100,000,000 | 51.8% | \$150,000,000 43.7% |
| 14 | Common Equity | \$93,082,000 | 48.2% | \$93,082,000 27.1% |
| 15 | Total Capital | \$193,082,000 | 100.0% | \$343,082,000 100.0% |

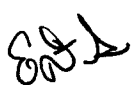
[A] 2013 actual financial information

[B] Column [A] adjusted to reflect issuance of an additional \$50M of long-term debt.

* Calculated using Net Income vs. the Operating Income usually used by Staff

MEMORANDUM

TO: Gerald Becker
Executive Consultant III
Utilities Division

FROM: Edward Stoneburg 
Electric Utilities Engineer
Utilities Division

DATE: July 29, 2014

SUBJECT: UNS ELECTRIC INC.'S FINANCING APPLICATION – ENGINEERING
ANALYSIS (DOCKET NO. E-04204A-13-0447)

I. INTRODUCTION

UNS Electric, Inc. (“UNS Electric” or “Company”), a subsidiary of UniSource Energy Services, Inc. (“UES”), submitted an application (“Application”) to the Arizona Corporation Commission (“Commission”) for authorization of various financing transactions as detailed in the Application. The purpose of this Application is 1) to refinance its revolving credit facility that expires in November 2016; 2) to increase the revolving credit by \$100 million; 3) refinance long-term indebtedness maturing in August 2015; 4) to increase the amount of long-term indebtedness by up to \$80 million; 5) finance the purchase of a 25 percent (137.5 MW) interest in the 550 MW Gila River Unit 3 Generating Station combined cycle gas turbine unit (“Gila River”), by allowing UNS Electric to issue additional debt up to \$35 million and accept new equity contributions up to \$35 million; 6) provide security for any financing transactions; and 7) enter into these financings through December 31, 2019. The requested authority is intended to replace the financing authority granted in Decision No. 71917, which expires on December 31, 2014. This memorandum presents Staff’s engineering review and conclusions regarding the Application.

II. UNS ELECTRIC OVERVIEW

UNS Electric is a vertically integrated electric utility serving approximately 92,500 retail customers in Mohave and Santa Cruz Counties with a peak demand of 427 MW in 2013. UNS Electric currently owns 153 MW of conventional gas fired generation capacity and makes market capacity purchases (conventional and renewable) to meet the remainder of its demand net of distributed generation and energy efficiency efforts. Energy is delivered over UNS Electric’s network of 334 miles of transmission and subtransmission lines and 3,650 miles of overhead and underground distribution lines. UNS Electric’s total capital budget for the five year period 2014-

2018 is estimated at \$252 million. This includes \$54.8 million for the proposed acquisition of a 25 percent interest in Gila River in 2014.¹

III. ENGINEERING REVIEW OF UNS ELECTRIC CAPITAL BUDGET

Staff has reviewed UNS Electric's 2014-2018 capital budget using the following criteria:

- Is UNS Electric operating and maintaining its electric system in a reliable manner?
- Does the capital budget adequately address the needs of the projected customer and load growth in UNS Electric's service territory?
- Are the capital expenditures on generation, transmission and distribution infrastructure upgrades and new additions appropriate and reasonable?

Load and Customer Growth for UNS Electric

UNS Electric experienced an annual average peak demand growth rate of approximately 1.2 percent per year over the period, 2004-2013 and an annual average customer growth rate of 1.8 percent for the same time period as seen in Table 1.

Table 1

UNS Electric Peak Demand and Total Customers

| Year | Actual Peak Demand* | Percent Change | Actual Total Customers | Percent Change |
|--------------------------------------|---------------------|----------------|------------------------|----------------|
| 2004 | 383 | | 78,831 | |
| 2005 | 426 | 11.2% | 82,922 | 5.2% |
| 2006 | 417 | -2.1% | 86,884 | 4.8% |
| 2007 | 424 | 1.7% | 89,472 | 3.0% |
| 2008 | 409 | -3.5% | 89,987 | 0.6% |
| 2009 | 444 | 8.6% | 90,100 | 0.1% |
| 2010 | 456 | 2.7% | 90,802 | 0.8% |
| 2011 | 437 | -4.2% | 91,255 | 0.5% |
| 2012 | 438 | 0.2% | 91,820 | 0.6% |
| 2013 | 427 | -2.5% | 92,548 | 0.8% |
| Compound Annual Growth (2004 – 2013) | | 1.2% | | 1.8% |

*Includes the effects of weather variation

UNS Electric's peak demand has been relatively flat over the past 9 years, as shown by the data in Table 1, with the demand in 2005 and 2013 essentially the same and varying above and below these values in between.

¹ UNS Electric's affiliated company, Tucson Electric Power ("TEP"), is planning to acquire the other 75 percent interest in Gila River.

UNS Electric's current peak demand forecast reflects a moderate growth rate of 0.5 percent per year over the 2013 actual peak of 427 MW for the period 2014 – 2018 as shown in Table 2. The new customer growth reflected in this forecast is based upon county population growth estimates from HIS Global Insight and the Arizona Department of Commerce and a return to the pre-housing crisis customer count growth.

Table 2
UNS Electric Forecast Peak Demand

| Year | Forecast Peak Demand | Percent Change |
|------------------------------------|----------------------|----------------|
| 2014 | 425 | -0.5% |
| 2015 | 426 | 0.2% |
| 2016 | 428 | 0.5% |
| 2017 | 433 | 1.2% |
| 2018 | 438 | 1.2% |
| Compound Annual Growth (2013-2018) | | 0.5% |

Reliability

Utilities use numerical indices as a measure of an average customer's distribution service reliability, typically computed on an annual basis. The Institute of Electrical and Electronic Engineers ("IEEE") has adopted a standard definition for several reliability indices for electric distribution systems. The most commonly used reliability indices are System Average Interruption Frequency Index ("SAIFI"), System Average Interruption Duration Index ("SAIDI"), Customer Average Interruption Duration Index ("CAIDI") and Momentary Average Interruption Frequency Index ("MAIFI"). These indices, except MAIFI, are measured for service interruption of more than five minutes duration with or without major event days ("MED"). MEDs represent extreme conditions of outages, such as severe storms.

UNS Electric provided the values of the above noted reliability indices excluding the effect of MEDs as indicated in Table 3:

Table 3
UNS Electric Distribution Reliability Indices 2010-2013

| | 2010 | 2011 | 2012 | 2013 | Average |
|--------------------|-------|-------|-------|-------|---------|
| SAIFI | 0.88 | 1.5 | 1.5 | 1.8 | 1.4 |
| SAIDI (Minutes) | 53.92 | 107.3 | 100.5 | 109.4 | 92.8 |
| CAIDI (Minutes) | 61.17 | 71.0 | 68.8 | 61.3 | 65.6 |

These indices show that over the last four years, the average customer experienced between one and two service outages per year (SAIFI) with an outage duration of about one hour to about one hour and 11 minutes (CAIDI). In UNS Electric's last rate case, (Decision 74235 - December 31, 2013) while Staff found that UNS Electric's three-year average values for 2010 – 2012 probably show above average reliability compared to similar utilities, concern was expressed about the upward trend in SAIDI and SAIFI. As a result, UNS Electric agreed to implement a procedure to target annual maintenance toward its worst performing circuits identified by service area and reliability indices, which Staff believes should help reverse the upward trend.

UNS Electric System Losses

UNS Electric annual system losses range between 5.1 percent and 5.8 percent for the period 2009 – 2013, averaging 5.5 percent. This level of losses is reasonable for UNS Electric's system which is a combination of rural and urban areas and has little high voltage transmission.

UNS Electric Capital Budget

Staff has reviewed UNS Electric's capital budget for 2014 - 2018, the details of which are provided in Exhibit EFS-1. The capital budget provides for maintenance of power plants, infrastructure development, including transmission and distribution facilities for new services, new transmission lines and upgrades to the existing system, installation of new equipment, such as transformers, capacitors and voltage regulators, improvements to communication systems and radio communication system, acquisition of fleet equipment, and the acquisition of a 25 percent interest in Gila River.

The total budget for the 5 year period by budget area is shown in Table 4.

Table 4
Five Year UNS Electric Capital Budget 2014-2018
(\$Millions)

| Budget Area | Total Budget | Description |
|--|---------------------|---|
| Production – Maintenance | \$9.5 | Maintain Valencia and Black Mountain Generating Stations |
| Production – New Resources (Gila River 3) | 60.5 | \$54.8 for Gila River Generating Station Purchase, \$5.7 for ongoing capital maintenance in 2015-2018 |
| General – Plant, Facilities, Information Technology, Other | 4.5 | Power Plant Tools, Network & Computer, Tools, Safety |
| General – Communication | 9.8 | Substation connectivity, SCADA |
| General - Fleet Equipment | 15.7 | Fleet and Power Op Equip |
| New Business | 35.4 | Residential, Commercial new line extensions, Transformers, service |
| System Reinforcement | 78.7 | Distribution & Transmission Line New, Replacement & Betterment. |
| System Integrity & Restoration | 10.1 | Storm Damage and Restoration |
| Renewables | 27.5 | Solar / Renewable programs |
| Total | \$251.7 | |

With respect to the capital budget, excluding the proposed acquisition of Gila River, Staff evaluated UNS Electric's historical capital expenditures for the past three years compared to the projected capital budget as well as certain capital budget detail. A comparison of the average annual expenditures for 2011-2013 to the average annual expenditures for 2014-2018 is shown in Table 5.

Table 5
UNS Electric Average Annual Expenditures Comparison
2011-2013 Actual Versus 2014-2018 Budget
(Excludes Gila River 3)
(\$Millions)

| Budget Area | 2011-2013 Actual Average Annual Expenditures | 2014 – 2018 Budgeted Average Annual Expenditures |
|---|--|---|
| Production – Maintenance | 0.5 | 1.9 |
| General – Plant, Facilities, Information Technology, Other | 1.7 | 0.9 |
| General – Communication | 0.4 | 2.0 |
| General - Fleet Equipment | 1.4 | 3.1 |
| New Business | 1.9 | 7.1 |
| System Reinforcement | 13.1 (Excluding \$34 million in 2013 for Vail-Valencia 138kV Line)* | 15.7 |
| System Integrity & Restoration | 1.5 | 2.0 |
| Renewables | 6.0 | 5.5 |

* The 2013 Vail to Valencia 138kV line cost was excluded in this comparison as there are no large projects of this size anticipated in the next five years.

Compared to historical expenditures Staff found that UNS Electric's 2014 – 2018 capital budget reflects:

- an increase in projected annual expenditures for maintenance of Valencia and Black Mountain generating plants reflecting in part routine scheduled capital maintenance on combustion turbines, control system upgrades, and switch gear replacement;
- a decrease in projected annual expenditures for plant, facilities, information technology and other, primarily related to reduced facilities costs;
- an anticipated increase in projected annual expenditures for new business, reflective of the improving economy and projected customer count growth reflected in UNS Electric's load forecast;
- an increase in projected annual expenditures for Communications primarily for the installation of fiber optic communication equipment in 2014 and upgrading the Mohave dispatch radio system in 2017 and 2018;

- an increase in projected annual expenditures for fleet equipment in anticipation of normal replacement of fleet equipment, much of which was purchased shortly after UNS Electric acquired the system from Citizens in 2003; and
- maintaining approximately the same level of projected annual expenditures for system reinforcement, system integrity & restoration, and renewables.

Based upon this review, Staff believes these portions of the UNS Electric capital budget are reasonable and should allow UNS Electric to continue to serve its customers in a reliable manner.

Gila River Acquisition

UNS Electric's capital budget includes \$54.8 million for the proposed acquisition of a 25 percent share (137.5 MW) of Gila River. Based upon UNS Electric's responses to Staff data requests, UNS Electric sees the acquisition of Gila River as a genuine, unanticipated opportunity to acquire a power supply resource at a clear and significant discount, compared to the cost of acquiring new generating facilities. UNS Electric currently makes several hundred megawatts of market purchases to serve its load. This was recognized in UNS Electric's 2012 Integrated Resource Plan ("IRP") where, as UNS Electric points out in response to Staff data request STF 2.6, its Action Plan stated:

"UNS Electric will monitor the market for economically attractive plant acquisition opportunities. A low cost, multi-owner acquisition of an existing combined cycle gas fired power plant would enable UNS Electric to firm up its longer-term capacity needs while realizing economies of scale through a multi-owner plant configuration."

UNS Electric further comments in response to Staff data request STF 3.3 that:

"...Commission Decision No. 73884, which acknowledge the 2012 IRPs filed by TEP and UNS Electric, included recommendations from both Commission Staff and its IRP Consultants which concluded that the Arizona Load Serving Entities should consider joint planning and procurement efforts in the development or acquisition of new generation assets. Subsequently, TEP entered into an RFP [request for proposal] process to evaluate the potential alternatives to replace the capacity reductions that were being considered at the Springerville and San Juan Generating Stations.

Based on TEP's bid analysis, Gila River Unit 3 was chosen as the final bidder due the economic and operational advantages of its proposal. Furthermore, Gila River's unit capacity (550 MW) offered both TEP and UNS Electric an opportunity to meet [their] short-term resource needs with the acquisition of this large scale generation asset. For TEP, a 75 [percent] ownership interest in Gila River (413 MW) satisfied its near term reductions of baseload capacity from Springerville Unit 1 (197 MW) and San Juan Unit 2 (170 MW), thus creating an opportunity for UNS Electric with respect to the remaining capacity. For UNS Electric, a 25 [percent] ownership interest (137 MW) was an unanticipated opportunity for UNS Electric to acquire a

needed baseload and intermediate resource that fit UNS Electric's smaller load requirements at a clear and significant discount that will provide unique value to its customers."

A.A.C. R14-2-705 specifies the Commission's rules for the procurement of wholesale energy, capacity, and physical power hedge transactions by load-serving entities and, with specific exceptions, requires the use of a competitive procurement process. Staff requested UNS Electric to explain how it believes its acquisition of Gila River is in compliance with Rule 705 given UNS Electric did not issue its own competitive solicitation, but rather relied upon TEP's RFP. In response UNS Electric stated it believes it has complied with Rule 705 by relying on Rule 705(B)(5) which states:

"The load serving entity shall use an RFP process as its primary acquisition process for the wholesale acquisition of energy and capacity, unless one of the following exceptions applies: ... (5) The transactions present the load-serving entity a genuine, unanticipated opportunity to acquire a power supply resource at a clear and significant discount, compared to the cost of acquiring new generating facilities, and will provide unique value to the load-serving entity's customers."

In support of this, UNS Electric asserts that the purchase price of \$398/kW is a "clear and significant discount to the cost of acquiring new generating facilities." UNS Electric estimates the cost of a new combined cycle generating unit to be \$1,320/kW. Further, UNS Electric calculates the levelized cost of energy from Gila River to be \$79.72/MWh compared to \$113.14/MWh for new construction. Based upon UNS Electric's analysis the Gila River acquisition, compared to new construction, will save \$135.8 million in net present value revenue requirements over the 2015 – 2029 time frame compared to the operation of a new combined cycle unit, at an average capacity factor of 41.7 percent.

In addition, UNS Electric stated in response to Staff data request STF 3.3 that:

"The plant provides unique value to UNS Electric's customers due to its ability to easily serve both of UNS Electric's Mohave and Santa Cruz service areas, to the discounted purchase price and to the cost sharing and synergies with TEP that will further reduce the costs for UNS Electric's customers. The unanticipated opportunity was identified through the Rule 705 RFP process conducted by UNS Electric's sister company, TEP."

Staff's independent review of the installed cost of a new combined cycle power plant in the size range of Gila River found estimates ranging from \$950/kW to \$1,475/kW in 2014 dollars. While UNS Electric's estimate of \$1,320/kW is at the higher end of this range, the price of \$398/kW being paid by UNS Electric for Gila River is about 60 percent below even the lowest estimate for a new plant identified by Staff.

A point of reference for the capital cost of purchasing an existing plant is Salt River Project's ("SRP") acquisition of one power block at the Mesquite Generating Station combined cycle gas turbine plant located near Gila River and installed in 2002. SRP announced its intention to acquire Mesquite in December 2012. The acquisition price equated to approximately \$594/kW, about 50 percent greater than the price agreed to by TEP and UNS Electric for Gila River.

Staff also notes that a detailed comparison of Gila River to a new plant must take into account the fact that Gila River is over ten years old. This could impact plant maintenance costs, performance, and remaining life of Gila River compared to a new plant. Information provided by UNS Electric and Entegra, the current owner, indicate that UNS Electric has considered this issue. The plant completed a major inspection and overhaul in 2013 and UNS Electric has included appropriate levels of maintenance expenditures (capitalized and expensed) in its capital budget and in its economic analysis of the acquisition.

Staff also reviewed, under a protective agreement², TEP's *RFP for a Power Plant Purchase* and related results as well as a report by UNS Electric on its analysis of purchasing a 25 percent interest in Gila River. Of note is that TEP's RFP only requested proposals for TEP to acquire ownership in a power plant and did not request proposals for long term power purchase agreements. TEP used an independent monitor to ensure fair and equal treatment of all bidders, ensuring all potential bidders had access to the same information at the same time. A number of proposals for existing and new facilities, offering both ownership and short-term power purchase agreements with options to purchase the power plant at a later time were received by TEP.

Based upon TEP's analysis of all alternatives, TEP selected Gila River because it found it to be the lowest cost intermediate/baseload plant offered in the RFP. UNS Electric's report documented its needs as reflected in its 2012 IRP, how Gila River would fit those needs, and the relative economics of Gila River to other plant purchase options. In addition to being the lowest cost option, UNS Electric points out that Gila River is served by both the El Paso Natural Gas and Transwestern Pipeline Company, L.L.C., pipelines, providing access to the Permian, San Juan and Anadarko supply basins. Gila River's interconnection to the Palo Verde hub and existing transmission rights to Jojoba Switchyard also result in lower transmission costs relative to other proposals.

In its 2012 IRP UNS Electric showed market capacity exposure of 350 MW in 2015 declining to 150 MW in 2027, as it projected additions of new capacity and continued to work toward compliance with the Commission's energy efficiency and renewable energy standards. UNS Electric's IRP analysis identified the need for base load/intermediate gas fired capacity and, as indicated above, UNS Electric proposed in its IRP to monitor the market for a low cost, multi-

² Even though UNS Electric and Staff entered into a protective agreement, UNS Electric stated it was unable to provide detailed information on proposals submitted by third party proposals in response to TEP's RFP process and protected by confidentiality agreements without obtaining third party consent. For purposes of Staff's review of the reasonableness of the proposed acquisition of Gila River, Staff relied on confidential high level summary data provided by UNS Electric, however, in any future prudency review for inclusion of Gila River costs in rates Staff may need access to more detailed information.

owner acquisition of an existing combined cycle gas fired power plant which would enable UNS Electric to firm up its longer-term capacity requirements. In its 2014 IRP filing UNS Electric shows the effect the proposed acquisition of Gila River will have on reducing its market exposure. The acquisition of Gila River will reduce UNS Electric's reliance on the short term market from approximately 67 percent of its capacity needs to approximately 38 percent. While a significant reduction, it is still substantially higher than other utilities in Arizona and higher than suggested in the 2012 IRP Staff report.

UNS Electric's heavy reliance on short-term power purchases was a concern pointed out by Staff and its Consultant in UNS Electric's 2012 IRP. As stated in the 2012 IRP Staff Report and in the related Commission Decision No. 73884:

The cost and availability of [future short-term market purchases] are subject to a wide array of influences that are difficult, if not impossible, to predict. For example, if a large number of older coal-fired generating plants are retired in the western region, the availability of such purchases will decline dramatically, and the cost of such purchases will increase significantly. Reliance on short-term market purchases in a long-term plan is difficult, if not impossible, to justify. Instead, beyond a five-year horizon, the LSEs should only include additional demand-side management programs, additional supply-side resources, and long-term purchased power. (Emphasis added)

As discussed above, the Company has shown that the purchase of a 25 percent interest in Gila River by UNS Electric will substantially reduce its heavy reliance on short-term market purchases. In addition, based upon the information reviewed, Staff believes the acquisition price for Gila River is reasonable compared to the acquisition of a new combined cycle power plant. However, Staff is concerned that UNS Electric did not explicitly consider and compare this acquisition to a long-term power purchase agreement which would also reduce the reliance on short-term market purchases. The statement quoted above from the 2012 IRP Decision clearly indicates Staff's and the Commission's recognition that long-term purchased power agreements should be considered as a resource alternative, which UNS Electric did not do in making its decision to pursue acquisition of Gila River.

Based upon information provided by UNS Electric in response to Staff data requests, the acquisition of Gila River is projected to result in a cumulative net present value of revenue requirements savings of approximately \$7 million over the first fifteen years of operation with additional benefits likely to accrue beyond that point compared to purchasing from the market. The payback period for the acquisition is approximately twelve years based upon the cumulative net present value of revenue requirement savings. The projected savings result from reduced energy costs due to the lower heat rate associated with Gila River compared to the average market heat rate, and reduced market premiums for firm power to meet UNS Electric's firm load obligations offset by the fixed costs of owning and operating Gila River.

Staff does believe there will be reductions in available firm power in the market place and resulting upward pressure on prices over the next five to ten years for two main reasons which would support UNS Electric locking in capacity at this time. First, there is a projected decline of available capacity in the market place. Based upon Western Electricity Coordinating Council's 2013 Resource Adequacy analysis, the desert southwest is projected to reach the reference reserve margin of 13.6% by 2020. This analysis did not reflect the retirement of Four Corners 1, 2 & 3 (560 MW) and the potential retirement within this time frame of one Navajo Generating Unit (750 MW), and San Juan 2 & 3 (800 MW) for a total of 2,110 MW. This would reduce the reserve in the region to 7%. Second, there may be a potential increase in demand for natural gas combined cycle units based upon Environmental Protection Agency's proposed carbon reduction rules for existing power plants released on June 2, 2014. One major component of the proposed rules calls for reliance on increased dispatch of natural gas combined cycle generating units to reduce coal generation dispatch. It is also conjectured that this could result in California expanding to adjacent states to facilitate EPA rule implementation which could impact Arizona. These factors may also put upward pressure on the value of existing combined cycle generating units in the region.

IV. ACC COMPLIANCE

A check with the Utilities Division Compliance Section database indicates that as of July 24, 2014, UNS Electric is not delinquent on any compliance items.

V. CONCLUSIONS

Based on Staff's engineering review of UNS Electric's capital budget and related information provided by UNS Electric in response to Staff data requests, Staff concludes:

- UNS Electric is currently operating and maintaining its electric system in a reliable manner based upon UNS Electric reliability indices. As noted, however, there is an upward trend in SAIDI and SAIFI, and UNS Electric agreed in Decision No. 74235 to implement a procedure to target annual maintenance toward its worst performing circuits identified by service area and reliability indices, which Staff believes should help reverse the upward trend.
- UNS Electric's capital budget appears to adequately address the needs of the projected customer and load growth in UNS Electric's service territory. UNS Electric's capital budget anticipates capital expenditures to connect new customers, to provide continued capital improvements to the system both for serving increase system loads and to replace aging infrastructure, to maintain its power plants, and to upgrade general plant such as radio communication systems.
- UNS Electric's capital expenditures on its existing generation, and its transmission and distribution infrastructure upgrades and new additions appear appropriate and reasonable. The projected costs reviewed by Staff seem reasonable compared to UNS Electric's historic expenditures, which to date have resulted in reliable service, and also account for anticipated future needs. The acquisition price for Gila River is substantially below the cost of constructing a comparable new generating plant and

meets the needs for baseload/intermediate capacity identified in UNS Electric's 2012 IRP.

- Based upon Staff's review of UNS Electric's economic analysis and the Company's need to reduce its reliance on short term market purchases, Staff concludes the acquisition of Gila River appears reasonable. Staff is concerned that UNS Electric did not solicit long term purchase power agreements, but since Staff's evaluation of financing applications does not include a prudence review of the actions proposed by the requesting company, this concern is more appropriately addressed if and when UNS Electric seeks to recover the costs associated with Gila River in its rates. UNS Electric should be aware that Staff's review of any such future filing may include an evaluation of whether or not a long term power purchase agreement would have been a better alternative.
- Based upon a review by the Utilities Division Compliance Section, UNS Electric currently has no delinquent Commission compliance items.

These Staff conclusions do not imply any specific treatment of rate base for rate making purposes in any future rate filings by the Company.

DRAFT - UNS Electric CAPITAL BUDGET 2014-2018

EXHIBIT EFS-1

| Budget Area | 2014 | 2015 | 2016 | 2017 | 2018 | Total | Description |
|----------------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--------------------|---|
| Production – Maintenance | 2,480,798 | 2,176,367 | 2,505,014 | 734,897 | 1,632,313 | 9,529,389 | Maintain Valencia and Black Mountain Generating Stations |
| General – Plant | 26,133 | 26,352 | 25,906 | 25,859 | 25,493 | 129,743 | Power Plant tools |
| General – Communication | 3,470,113 | 803,951 | 779,890 | 714,408 | 4,046,534 | 9,814,896 | Substation connectivity, SCADA |
| General – Facilities | 589,675 | 515,390 | 514,883 | 364,331 | 288,128 | 2,272,407 | |
| General - Information Technology | 481,926 | 234,051 | 354,112 | 234,147 | 284,135 | 1,588,371 | Network & Computer |
| General – Other | 107,000 | 107,000 | 107,000 | 107,000 | 107,000 | 535,000 | Tools, Safety |
| General - Fleet Equipment | 2,691,545 | 2,387,143 | 3,296,536 | 3,702,895 | 3,629,913 | 15,708,032 | Fleet and Power Op Equip |
| New Business | 6,246,979 | 6,702,892 | 6,649,753 | 7,383,577 | 8,442,388 | 35,425,589 | Residential, Commercial new line extensions, Transformers, service |
| System Reinforcement | 16,817,133 | 13,940,457 | 10,288,427 | 15,180,323 | 22,479,212 | 78,705,552 | Distribution & Transmission Line New, Replacement & Betterment. Distribution and Transmission Substation New, Replacement and Betterment. |
| System Integrity & Restoration | 1,983,446 | 2,051,957 | 2,016,590 | 2,039,689 | 2,013,833 | 10,105,515 | Storm Damage and Restoration |
| Renewables | 4,324,958 | 6,516,090 | 5,670,193 | 5,581,625 | 5,396,911 | 27,489,777 | Solar / Renewable programs |
| Subtotal | 39,219,706 | 35,461,650 | 32,208,304 | 36,068,751 | 48,345,860 | 191,304,271 | |
| Production - New resources | 54,750,000 | 2,097,305 | 1,365,362 | 1,383,871 | 902,843 | 60,499,381 | \$54.8 for Gila River Generating Station Purchase, \$5.7 for ongoing capital maintenance in 2015-2018 |
| Total | 93,969,706 | 37,558,955 | 33,573,666 | 37,452,622 | 49,248,703 | 251,803,652 | |